United States Court of Appeals

for the Second Circuit

APPELLANT'S PETITION FOR REHEARING EN BANC

76-7528

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ORIGINAL

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P/S

Docket No. 76-7528

UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, and THE NATIONAL BANK OF COMMERCE OF DALLAS (AS TRUSTEE OF THE OMEGA-ALPHA, INC. POOL TRUST),

Plaintiffs-Appellants-Petitioners,

-against-

HENRY ORENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE, INC., BERNSTEIN-MACAULAY, INC., ROGER S. BERLIND, AND SANFORD I. WEILL,

Defendants,

-and-

FIRST NATIONAL CITY BANK,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

PETITION FOR REHEARING AND SUGGESTION THAT THE REHEARING BE IN BANC

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ON APPEAL FROM THE UNITED STATES DISTRICT COURT
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PETITION FOR REHEARING AND SUGGESTION
THAT THE REHEARING BE IN BANC

Plaintiffs-appellants United States Steel and Carnegie Pension Fund, Inc. (the "Pension Fund"), Connecticut Mutual Life Insurance Company ("Connecticut Mutual") and the National Bank of Commerce of Dallas (the "Dallas Bank") petition this Court, pursuant to Rules 35(b) and 40 of the Federal Rules of Appellate Procedure, for a rehearing of their appeal from a judgment entered in the United States District Court for the Southern District of New York which dismissed their complaint against defendant First

National City Bank ("Citibank") under the Securities Act of 1933, the Securities Exchange Act of 1934 and the common law. The District Court's judgment was affirmed on June 16, 1977 by a three judge panel of this Court.* Because the decision of the Panel strayed substantially from prior opinions of this Circuit under the federal securities laws, petitioners respectfully suggest that the rehearing be in banc.

ISSUES ON REHEARING

Did the Panel of this Court err as a matter of law in holding:

1. That good faith is an adequate defense under the federal securities laws when plaintiffs, in a misrepresentation case involving direct personal dealings, prove that the defendant had actual knowledge of the falsity of the facts misstated and concealed; and

2. That Citibank was not an insider under the federal securities laws and had no affirmative duty of disclosure to plaintiffs?

STATEMENT OF THE CASE

This action arose out of a private placement of $5,250,000 in convertible subordinated notes of Topper Corporation ("Topper") on September 28, 1971 (the "Private Placement"). At the time of the Private Placement, Topper was engaged in the business of manufacturing and marketing toys for boys and girls

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*Circuit Judge Oakes, Senior Circuit Judge Medina, and District Judge Mishler.

(Fdg P1).* Since 1966 Citibank and Topper were parties to a Finance Agreement pursuant to which Citibank advanced moneys to Topper on a secured basis and acted as agent for other lenders that at various times also advanced moneys to Topper (Fdg P48). In addition, since 1950 both the Pension Fund and Citibank were parties to an agreement under which Citibank agreed, for an annual fee, to provide investment advisory and other services to the Pension Fund (Fdg D272).

Following a three week bench trial,** the District Court found that in the months prior to the Private Placement Topper was in the midst of a severe financial crisis (Fdgs P174-P195), that each significant fact relating to that financial crisis was known to Citibank (Fdgs P239-P296), that none of these facts were known to plaintiffs (Fdg P193), and that in connection with the Private Placement Citibank nevertheless gave a favorable report on Topper's current financial condition to the Pension Fund without revealing any of the adverse information that Citibank knew concerning Topper's financial difficulties (Fdg P20). Both the Pension Fund and Connecticut Mutual, the District Court found, relied on this favorable report to their detriment (Fdg P22).

The District Court also found that on three occasions prior to its favorable report to the Pension Fund, Citibank extended bridge loans to Topper for the express purpose of enabling

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*The designations "Fdg P" and "Fdg D" refer to those Findings of Fact proposed by plaintiffs and defendant, respectively, which were subsequently adopted by the District Court; they appear at pages A41-A348 of the Joint Appendix.

**Plaintiffs' claims against five other defendants were settled prior to trial.

Topper to stay in business until the Private Placement (Fdgs P275, P280, P288), but only granted these bridge loans on the condition that Topper consummate the Private Placement and remit its proceeds to Citibank (Fdgs P275, P280, P288). Significantly, the lower court found "that Topper was only able to continue operations during the Summer of 1971 as a result of" the Citibank bridge loans (Fdg P193). Neither the existence nor the conditions of the bridge loans were revealed to plaintiffs (Fdg P193) and, despite their significance, were never considered or discussed by the Panel or the District Court. The foregoing facts, the District Court held, were insufficient to sustain any cause of action against Citibank because the particular Citibank officer, who reported to the Pension Fund that all was well, "acted in good faith" and had no "conceivable motive to mislead" the Pension Fund (A27-A28).*

THE OPINION OF THE PANEL

In affirming the judgment of the lower court, the Panel stated that the "case presented only fact questions which were resolved against appellants." Slip Op. at 4226.** This was plain error. With one exception, plaintiffs' appeal was limited to questions of law involving policies which, prior to this decision, formed the cornerstone of this Circuit's approach to securities fraud litigation.

The Panel was lead to this error because it paid litle

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*Page references prefixed "A" are to the Joint Appendix on appeal.

**The Slip Opinion is annexed hereto as Exhibit A.

heed to the facts, found below and undisputed on appeal,* from which the legal questions arose. Thus:

A.

The opinion of the Panel stated:

> "Collections in past years had similarly run well behind projections, and the seasonal nature of the business had caused the percentage of past due accounts to rise in previous summers." Slip Op. at 4225.

But the District Court found:

> "[P]rior to the end of 1970 [cash] shortfalls were generally insignificant, typically amounting to less than $500,000," lasted for a "limited duration," were "collateralized by eligible receivables," and "recovered within a month" (Fdg P250). In contrast, the "$10 million cash shortfall which occurred during the critical months of May through September . . . was completely without precedent in the Topper account" (Fdg P254).

B.

The opinion of the Panel stated:

> "In mid-1971, Topper began to extend credits on the unsold toys which in effect eliminated much of the accounts receivable. This policy was never revealed to Citibank officials who believed Topper was experiencing usual seasonable difficulty in collecting on past due accounts." Slip Op. at 4223.

On the other hand, the District Court found:

> "At the same time past due receivables were increasing at record levels in the summer of 1971, Citibank learned that a substantial and non-seasonal amount of credits were being issued by Topper for customer returns and other concessions . . . . In terms of the significance of this data . . . the amount of outstanding credits issued by

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*Each of the facts referred to in this Petition are drawn solely from findings of fact adopted by the District Court under Rule 52 of the Federal Rules of Civil Procedure.

Topper by the summer of 1971 was 'substantial' viewed against both collections and sales . . . ." (Fdg P263).

C.

The opinion of the Panel stated:

> "There was no evidence that Waldman knew of Topper's concession practices before the placement." Slip Op. at 4225.

But the District Court in fact found:

> "Most basically Citibank was aware that as a matter of business practice Topper granted concessions to major customers who were unable to sell Topper inventory" (Fdg P90) and "Citibank took steps to protect its collateral from the 'dilution' to sales and receivables caused by Topper's concessions" (Fdg P97) by "establish[ing] a reserve for returns and other concessions on its own books, above and beyond the 20% reserve for dilution built into the lending formula" (Fdg P98).

D.

The opinion of the Panel stated:

> "It appears that [the Pension Fund] was in the best position to discover Topper's financial instability. The firm's customer contracts and regularly prepared account control documents were available for [its] inspection; [the Pension Fund] simply never reviewed them." Slip Op. at 4225.

While the District Court found:

> "In addition to daily communications with Topper, Citibank received by courier from Topper a variety of detailed information on a daily and monthly basis . . ." (Fdg P211). "To make sense of this mass of data, and to afford ready oversight over the Topper account, Citibank programmed the data received from Topper each business day into a computer which in turn provided, among other things, daily loan 'advance sheets' reflecting the 'essential results of all daily records with regard to the Topper account . . . ." (Fdg P212).

In short, not disputed on this appeal, but ignored by the Panel's opinion, was that when Citibank reported to the Pension Fund that "there were no current problems with the Topper

account and that Citibank anticipated [no problems]" (Fdg P20), there were in fact "several and severe financial problems (Fdg P193) at Topper and the officer Citibank chose to report had actual knowledge of each of them (see, e.g., Fdgs P254, P259, P264, P267, P275, P288). Thus Citibank reported "that Topper's principal product line was faring well at retail" (Fdg P20), but the Court found that Citibank knew the same product line had in fact failed to sell at retail (Fdg P259) and was being returned in substantial quantities by Topper customers (Fdg P263). Citibank reported "that Topper had performed well in a Citibank audit of its receivables" (Fdg P20), but the Court found Citibank in fact knew that Topper's past due receivables had increased 300% from the end of June to the end of July (Fdg P257), that by the end of August 1971 of past due receivables was five times the amount outstanding for the comparable period in 1970 and nearly fourteen times as great as in 1969 (Fdg P258), and that nearly 50% of Topper receivables were deemed unworthy as collateral for advances by Citibank (Fdg P264).

ARGUMENT

I.

Prior to the Panel's Decision, the Law in the Circuit Was Uniform That an Actual Knowledge Test Sufficed to Establish Scienter Under the Federal Securities Laws

From such facts, none of which were mentioned in the Panel's opinion, arises the legal question which the Panel never addressed: Is good faith an adequate defense in a securities fraud case once plaintiffs establish actual knowledge of the falsity of the material facts misstated or concealed by the

defendant? The Panel and the trial court were of the opinion that good faith was such a defense; but a long line of authority in this Circuit and elsewhere is of the opinion that judgment was due the plaintiffs because "actual knowledge of falsity is amply sufficient . . . " to establish liability. Heit v. Weitzen, 402 F.2d 909, 914 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969).*

In holding to the contrary, the lower court misapprehended the role of good faith under the federal securities laws. It has long been clear, both before and after Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976),** that good faith is only a defense when actual knoweldge is absent. Though elusive,*** the

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*See SEC v. Universal Major Industries Corp., 546 F.2d 1044, 1047 (2d Cir. 1976)("that [defendant's] acts were peformed with knowledge . . . is sufficient to establish scienter"); Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 33 (2d Cir. 1976)("[defendant] was actually aware of the [misrepresented] facts"); Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir.), cert. denied, 414 U.S. 857 (1973)("it must be established that the defendant was to some extent cognizant of the misstatement or omission"); Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 364 (2d Cir.), cert. denied, 414 U.S. 910 (1973)("the standard for determining liability . . . is whether plaintiff has established that defendant . . . knew the material facts that were misstated or omitted"); Globus v. Law Research Service, Inc., 418 F.2d 1276, 1291 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970)("evidence . . . of knowledge [is sufficent]").

**While relevant decisions have been sparse since Hochfelder, "there has not been any inter-Circuit controversy that scienter short of specific intent to defraud is sufficient to support liability." Sundstrand Corp. v. Sun Chemical Corp., [1976-77] Fed. Sec. L. Rep. (CCH) ¶ 95,887, at 91,259 n.16 (7th Cir. Feb. 23, 1977).

***Appropriately described as a term equally elusive as its opposite, bad faith, both terms "remain cherished resorts of lawyers (and sometimes of judges) who have little else to conjure with." 2 A. Bromberg, Securities Law § 8.4 (561) at 204.204 (1975).

term good faith is generally used to refer to a diligent effort to learn the facts. While various provisions of the securities laws provide that defendants who misstate or conceal material facts may avoid liability by showing they acted in good faith, or exercised due diligence, they may do so if, and only if, they also prove the absence of actual knowledge of material facts misstated or omitted.* This much is clear from Hochfelder, which cited legislative history to the effect that:

> "'. . . The defendant may escape liability by showing that the statement was made in good faith.' S. Rep. No. 792, supra, at 12-13 (emphasis supplied)." 425 U.S. at 206.

This legislative history, however, was relied upon by the Court in the context of a defendant who had no knowledge of the adverse facts at issue and was referred to simply to demonstrate that negligence was an insufficient predicate for liability under § 10(b). Significantly, the legislative history quoted by Hochfelder related not to § 10(b), but to § 18 of the 1934 Act, which reads on false filings with the Securities and Exchange Commission, and specifies liability "unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." 15 U.S.C. § 78r(a) (emphasis added). It follows, then, that "[i]f actual knowledge is found,

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*See, e.g., § 11 of the 1933 Act, 15 U.S.C. § 77k ("no reasonable ground to believe . . . that the statements therein were untrue"); § 12 of the 1933 Act, 15 U.S.C. § 77l (defendant "did not know, and in the exercise of reasonable care could not have known"); § 15 of the 1933 Act, 15 U.S.C. § 77o ("unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts"); § 18 of the 1934 Act, 15 U.S.C. § 78r ("unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading").

good faith is of course negated." Bucklo, Scienter and Rule 10b-5, 67 Nw. U.L. Rev. 562, 570 n.35 (1972).* Confirming this view, the Seventh Circuit recently ruled that "good faith is not appropriate as a defense to reckless or intentional behavior." Sundstrand Corp. v. Sun Chemical Corp., [1976-77] Fed. Sec. L. Rep. (CCH) ¶ 95,887, at 91,259 n.17 (7th Cir. Feb. 23, 1977). See McLean v. Alexander, 420 F. Supp. 1057, 1080-82 (D. Del. 1976).

Once actual knowledge is found in a direct misrepresentation case, good faith can only mean the lack of evil motive or intent to deceive.** However, even in criminal proceedings, the Government is "not bound to show evil motive" or to prove "that defendants were wicked men with designs on anyone's purse," but rather must simply show for conviction that defendant's made "a statement knowing it to be false." United States v. Simon, 425 F.2d 796, 808-09 (2d Cir. 1969), cert. denied, 397 U.S. 1006 (1970). As Globus v. Law Research Service, Inc., 287 F. Supp. 188, 197-98 (S.D.N.Y. 1968), modified, 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970), which rejected the contention that a showing of "an intent to deceive, to cheat, and to hoodwink" was required, 287 F. Supp. at 197, observed:

> "To impose upon the civil plaintiff the burden of demonstrating intent to defraud when no such burden is

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*This article was cited with approval by Hochfelder to demonstrate that scienter, not negligence, was the standard required by Section 10(b). Significantly, Bucklo concluded that "scienter should be interpreted to mean knowledge of the facts," 67 Nw. U. L. Rev. at 570, and this applies to defendants, such as Citibank here, who had "known of the falsity of the statements, but hoped that, with additional experimentation, the material would be suitable." Id. at 568.

**Tending to support that it was in this sense that the lower court used the term good faith was the parallel finding that neither the officer who gave the misleading report or Citibank "had any conceivable motive to mislead" plaintiffs (A27-A28) (emphasis added).

imposed upon the Government in a related criminal case arising out of the same statement or document would create an anomalous result." 287 F. Supp. at 198.

By substituting a standard which necessarily relies upon testimonial and demeanor evidence of the defendants' state of mind* -- categories of evidence generally disfavored in this Circuit** -- for an objective standard based on a measure of what the defendant actually knew against what that same defendant said, the Panel undercut effective enforcement of the federal securities laws.

II.

The Panel's Decision Substantially Narrowed the Law in This Circuit on Insider Liability

Apart from whether the content of Citibank's report was false and misleading, the fact that material and adverse information was omitted from the report is undisputed. This, too, was insufficient for liability, the Panel concluded, because Citibank was not an insider within the meaning of the federal securities laws (Slip Op. at 4226), and thus had no affirmative duty of disclosure to plaintiffs. In reaching this conclusion, the Panel once again overlooked findings of fact adopted by the District Court, and ignored a substantial body of law, insider and otherwise, on affirmative obligations to disclose. The net result of the Panel's holding was to repeal the maxim that "those persons who are in a special relationship with a company and privy to its internal affairs . . . thereby suffer correlative duties" in connection with sale of securities. Cady, Roberts & Co., 40 S.E.C.

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*It has been said that the "devil himself does not know the thought of a man," Y.B. 17 Edw. IV pl. 2 (1478).

**See, e.g., United States ex rel. Brennan v. Fay, 353 F.2d 56, 59 (2d Cir. 1965); II J. Wigmore, Evidence § 274 at 109 (3d ed. 1940).

907, 912 (1961); see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848, 862 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

Here Citibank was plainly an insider under the federal securities laws.* The bank possessed a wide range of financial data not known by any plaintiff or the investing public (Fdgs P209-P211), and, most significantly, had the means to make sense out of the information in its possession. Each business day Citibank, in addition to consulting with Topper officers, received voluminous schedules and reports from the Topper finance department (Fdg P210). These materials were then fed to a Citibank computer that was programmed to prepare a daily report called an "advance sheet" which reflected the essential results of all daily records prepared by Topper (Fdgs P212-P213). With this information at hand, Citibank was able to keep abreast of each adverse financial development which occurred at Topper in 1970 and 1971.

Citibank was much more than an insider here, however, and the case for imposing an affirmative duty of disclosure that much stronger. Thus:

¶ The trial court found that Citibank voluntarily agreed to provide information on Topper's financial condition

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*"In determining whether a person, not a director or officer, is a corporate insider . . . the test is whether he had such a relationship to the corporation that he had access to information which should be used 'only for a corporate purpose and not for the personal benefit of anyone.'" Ross v. Licht, 263 F. Supp. 395, 409 (S.D.N.Y. 1967). This clearly includes banks, for as a partner in the law firm of Shearman & Sterling, long-time counsel to defendant Citibank, recognized:

> "The prudent commercial lender is apt to know as much about the inner affairs of his actual or potential borrowers as many members of the borrower's corporate family." Harfield, Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments, 86 Banking L.J. 869, 873 (1969).

to the Pension Fund (Fdgs P305-P307) and then failed to reveal a whole range of materially adverse facts within its possession.*

¶ Citibank reaped substantial financial benefits when the proceeds of the Private Placement were turned over to the bank (Fdgs P293-P295).**

¶ Citibank was substantially involved in the transaction: It made the Private Placement possible by agreeing to extend the bridge financing required to keep Topper in business (Fdgs P275, P281, P288) and gave a favorable report on Topper's financial condition to the lead investor in the Private Placement (Fdg P20).***

¶ Citibank enjoyed a 20-year relationship with the Pension Fund under which Citibank, for an annual fee of $100,000 or so, undertook to provide investment advisory and other

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*Once Citibank agreed to say anything about its Topper account, it was then obliged to reveal all material facts within its possesion. "'If he speaks at all, he must make a full and fair disclosure.'" Mid-States Insurance Co. v. American Fidelity & Casualty Co., 234 F.2d 721, 729 (9th Cir. 1956).

**"[T]he factor of gain is an important, if not dispositive, consideration," Fischer v. Kletz, 266 F. Supp. 180, 190 (S.D.N.Y. 1967), in determining whether an affirmative duty of disclosure exists. As the Ninth Circuit remarked, principal among the factors in determining "the scope of the duty imposed" by Rule 10b-5 is "the benefit that the defendant derives from" the securities transaction to which his conducted related. White v. Abrams, 495 F.2d 724, 731, 735-36 (9th Cir. 1974); see 2 A. Bromberg, Securities Law § 8.5 (584) at 208.46-49 (1975).

***A similar pattern of encouraging or promoting a securities transaction while possessing negative information on the issuer was deemed sufficient to give rise to an affirmative duty of disclosure in Fischer v. New York Stock Exchange, 408 F. Supp. 745, 751 (S.D.N.Y. 1976), rev'd on other grounds sub nom. Lank v. New York Stock Exchange, 548 F.2d 61 (2d Cir. 1977). Lank was reversed because the duty ran to investors, not to Exchange members.

services to the Pension Fund, including, on at least six occasions, providing the Pension Fund with information about clients which had lending arrangements with the bank in connection with private placements the Pension Fund was considering (Fdgs D276-D279).*

Viewed separately, each of these circumstances provides an independent basis for imposing an affirmative duty of disclosure on Citibank. But if any alone is insufficient, "the existence of all the others in addition making such a combination as rendered it the plain duty of the defendant to speak" under the special facts doctrine.** Strong v. Repide, 213 U.S. 419, 431 (1909). As the Supreme Court concluded in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972),

> "It is no answer to urge that ... [Citibank] may have made no positive representation or recommendation. The defendants may not stand mute while they facilitate [the wrong]."

CONCLUSION

Plaintiffs-appellants request that this petition for rehearing be granted and suggest, in light of the departure from

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*"Apart from the technical elements of a fiduciary relationship, the circumstances surrounding these parties' various dealings made it incumbent upon the defendant to truthfully disclose facts in his possession . . . ." Consolidated Oil & Gas, Inc. v. Ryan, 250 F. Supp. 600, 607 (W.D. Ark.), aff'd, 368 F.2d 177 (8th Cir. 1966).

**See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

the established law of this Circuit, that the rehearing be *in banc*.

Dated: June 30, 1977

Respectfully submitted,

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EXHIBIT A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

JUN 24 1977

No. 878—September Term, 1976.

(Argued April 27, 1977 Decided June 16, 1977.)

Docket No. 76-7528

UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., CONNECTICUT MUTUAL LIFE INSURANCE COMPANY, and the NATIONAL BANK OF COMMERCE OF DALLAS (AS TRUSTEE OF THE OMEGA-ALPHA, INC. POOL TRUST),

Plaintiffs-Appellants,

—against—

HENRY ORENSTEIN, FIRST NATIONAL CITY BANK, HAYDEN STONE INC., BERNSTEIN-MACAULEY, INC., ROGER S. BERLIND, and SANFORD I. WEILL,

Defendants,

—and—

FIRST NATIONAL CITY BANK,

Defendant-Appellee.

Before:

MEDINA and OAKES, *Circuit Judges*, and
MISHLER, *District Judge.**

Appeal from a judgment entered September 21, 1976, in the District Court for the Southern District of New York

* Of the Eastern District of New York, sitting by designation.

after a three-week non-jury trial before the Hon. Whitman Knapp, *District Judge*, dismissing plaintiffs-appellants' complaint which charged First National City Bank with violations of §10-b of the Securities Exchange Act of 1934, §17a of the Securities Act of 1933, and common law.

Affirmed.

ROBERT A. BICKS, New York, New York (Joseph P. Dailey, Randall T. Sims and Breed, Abbott & Morgan, New York, New York, of counsel), *for Plaintiffs-Appellants.*

W. FOSTER WOLLEN, New York, New York (Michael W. Lillie, Barbara Bamford, Thomas M. Geisler, Jr., and Shearman & Sterling, New York, New York, of counsel), *for Defendant-Appellee.*

PER CURIAM:

In 1971, Topper Corporation, then the fifth largest domestic toy manufacturer, proposed a private placement of convertible subordinate debentures in order to reduce its over-advanced position under a $20 million, non notification, revolving loan agreement with the First National City Bank ("Citibank"). With the aid of Hayden Stone, Inc., a leading investment banker, and Arthur Young & Co., a large firm of certified public accountants, both a Private Placement Memorandum and public offering prospectus were drawn for distribution to potential participants. In July, 1971, the opportunity was brought to the attention of Henry Thompson, the investment manager of the United States Steel and Carnegie Pension Fund ("Pension Fund"). Thompson, a seasoned securities analyst, considered the placement a potentially sound Fund invest-

ment and set out on a month long investigation of Topper's financial posture.

The company's audited financial statements for fiscal year 1970 and the interim statements for the first half of 1971 to which Thompson first turned revealed a financially stable company which was experiencing steady profits and increased sales. In actuality, however, Topper was laboring under serious financial problems. Their year-end figures had been inflated by $14 million in December shipments under what was known as the "Spring 1971 Program": while treated as part of the 1970 sales, the merchandise was invoiced on extended credit terms. Thompson knew of these machinations and understood that profits were tied to the company's ability to collect on the accounts receivable, but he was unaware of Topper's hidden marketing practice of granting concessions to customers who were unable to sell their products at retail. Although Thompson was repeatedly assured by Hayden Stone and Topper officials that the "Spring 1971 Program" was faring well, Topper's products were in fact stockpiling on retailer's shelves. In mid-1971, Topper began to extend credits on the unsold toys which in effect eliminated much of the accounts receivable. This policy was never revealed to Citibank officials who believed Topper was experiencing usual seasonal difficulty in collecting on past due accounts.

During his visit to the Topper plant in August, 1971, Thompson learned that Citibank was the firm's principal financier and that Edward Waldman, a bank vice-president, administered the $20 million revolving loan. Thompson contacted one Walter Jeffers, another Citibank officer, who was in charge of the Pension Fund's accounts under a long term custodial agreement pursuant to which Citibank administered the Fund's assets and provided quarterly investment advice. Thompson requested that Jeffers have Waldman call him.

On August 27, 1971, Waldman called Thompson and a five-minute conversation ensued which became the basis of this litigation. Waldman voiced confidence in the company's management; while he expressed the belief that Henry Orenstein, the firm's president, was chiefly responsible for Topper's growth, Waldman noted that Topper's financial officers had tight control over audits and had done an excellent job estimating production costs. More importantly, Waldman indicated that the Topper account had long been satisfactory, and that he neither knew of, nor foresaw any problems. Waldman, however, refused to commit himself upon Thompson's request for investment advice.

His investigation complete, Thompson reported favorably on the Topper placement, and in September 1971, appellants invested $5.25 million in the convertible debentures. The company's hidden reliance on consignment sales, however, led to its financial collapse; in May, 1973, Topper was adjudged a bankrupt. Appellants thereafter commenced this action[1] charging Citibank with violations of §10(b) of the Securities Exchange Act of 1934; 15 U.S.C. §78j(b), and §17(a) of the Securities Act of 1933, 15 U.S.C. §77q(a) and common law fraud. Appellants alleged that Waldman, aware that Citibank was to receive the proceeds of the private placement, deliberately misled Thompson into believing that Topper was in a sound financial state. Appellants argued that although Waldman knew of the sharp rise in past due accounts receivable and Topper's faltering sales, he failed to disclose the information in violation of the securities laws and his fiduciary duty under the Citibank-Pension Fund investment contract.

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1 All other defendants settled before trial.

The district court, rejecting appellant's claims, specifically found that Waldman had responded to Thompson's inquiry both honestly and in good faith; it further found that there was neither occasion for Waldman to engage in any philosophical conversation on Topper's business practices nor any reason for him to believe that Thompson was seeking advice under the then prevailing investment contract. The district court's findings are amply supported by the evidence. There was no evidence that Waldman knew of Topper's concession practices before the placement. Collections in past years had similarly run well behind projections, and the seasonal nature of the business had caused the percentage of past due accounts to rise in previous summers. An official of Citibank broached the subject of the overdue accounts with Orenstein during the summer of 1971, only to accept his assurances that it would be competitively unsound to press for collections during the slow summer months and before the advent of a new line.

It appears that Thompson was in the best position to discover Topper's financial instability. The firm's customer contracts and regularly prepared account control documents were available for his inspection; Thompson simply never reviewed them. Moreover, unlike Citibank which was constrained by the non-notification arrangement, Thompson had direct access to Topper's customers. Yet, he never questioned them as to the finality of Topper's sales.

When the five minute conversation is properly viewed in the context of Thompson's month long investigation, it is reasonable to conclude that Thompson's inquiry was but a mere credit check and not a request for investment advice. The Pension Fund-Citibank investment contract contemplated only quarterly meetings where the bank's

then current investment policies on publicly traded securities were discussed. Notably, when Thompson informed his superior that he asked Waldman his opinion of the placement, Thompson was told he had no right to make that inquiry. Significantly Thompson made only passing reference to the Waldman conversation in drawing his recommendation memorandum for the Fund's Finance Committee.

Appellants argue that once Waldman agreed to provide information on Topper's financal condition, he was required to make a full and fair disclosure. Their reliance on *Mid-States Insurance Co.* v. *American Fidelity & Casualty Co.*, 234 F.2d 721 (9th Cir. 1956) and *Bowman & Bourdon, Inc.* v. *Rohr*, 296 F. Supp. 847 (D. Mass), *aff'd*, 417 F.2d 780 (1st Cir. 1969) is misplaced. Those cases involved deceptive statements by a seller or insider. Citibank was neither an insider nor a participant in the placement of the loan. That Citibank stood to receive the proceeds from the placement was made clear in the Private Placement Memorandum.

Thompson carried on an exhaustive investigation which led him and the Fund's Finance Committee to believe the placement was a sound investment. Ford Motor Credit Company evidently shared appellants' belief in Topper's financial stability, as it extended a $7 million loan about the same time the private placement was effected. The case presented only fact questions which were resolved against appellants.

Affirmed.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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UNITED STATES STEEL AND CARNEGIE PENSION FUND, INC., et al.,

Plaintiffs-Appellants-Petitioners,

-against-

HENRY ORENSTEIN, et al.,

Defendants,

-and-

FIRST NATIONAL CITY BANK,

Defendant-Appellee.

- -x

AFFIDAVIT OF SERVICE ON PERSON IN CHARGE

Docket No. 76-7528

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

LAURENCE MOLINELLI, being duly sworn, says: I am employed in the office of Breed, Abbott & Morgan, 1 Chase Manhattan Plaza, New York, N.Y. 10005, attorneys for the Plaintiffs-Appellants-Petitioners in the above action.

On the 30th day of June, 1977, I served the annexed PETITION FOR REHEARING AND SUGGESTION THAT THE REHEARING BE IN BANC on the attorney(s) listed below by delivering the same to and leaving the same with the person in charge of said office(s).

SHEARMAN & STERLING
53 Wall Street
New York, New York 10005.

Sworn to before me this
30th day of June, 1977.

Edna G. Watrous

EDNA G. WATROUS
NOTARY PUBLIC, State of New York
No. 24-9549550
Qualified in Kings County
Certificate Filed in New York County
Commission Expires March 30, 1978

Laurence Molinelli

Laurence Molinelli